

IT 02-16

Tax Type: Income Tax

Issue: Net Operating Loss (General)

Unitary – Inclusion of Company(ies) In A Unitary Group

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS**

**THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS**

v.

**"INTERNATIONAL BROTHERHOOD OF
PACHYDERM PRODUCERS, INC.",**

Taxpayer

No. 00-IT-0104

FEIN: 42-0838666

TYE: 1992, 1993, 1994,
1995, 1996, 1997

**Ted Sherrod
Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Appearances: Special Assistant Attorney General Ronald Forman on behalf of the Illinois Department of Revenue; Fred Marcus, Esq. and C. Eric Fader, Esq. of Horwood, Marcus & Berk, Chtd., on behalf of "International Brotherhood of Pachyderm Producers, Inc."

Synopsis:

This matter involves Notices of Deficiency ("NOD's") the Illinois Department of Revenue ("Department") issued to "International Brotherhood of Pachyderm Producers, Inc." ("IBPPI"), as designated agent for ""IBPPI's" Meat Processing Group consisting of "IBPPI" and its subsidiaries, for 1992, 1993 and 1994, and for 1995, 1996 and 1997. "IBPPI" timely protested these NOD's and requested a hearing thereon. In its protest, the taxpayer requested that this tribunal decide whether the Department properly computed

the application of net operating loss carryforwards to 1992 and 1993. The disallowance of these carryforwards pushed net operating losses (“NOL’s”) for 1986 and 1987 taken in 1993, 1994 and 1995 to earlier years, and resulted in the denial or reduction of these NOL’s for 1993, 1994 and 1995. Prior to the hearing, the Department and the taxpayer submitted agreed stipulations of fact, and exhibits, and agreed that this case should be decided on the basis of these documents and briefs submitted by the parties. Following a review of the documents of record, it is recommended that this matter be resolved in favor of the Department.

Findings of Fact:

1. The Department’s *prima facie* case, inclusive of all jurisdictional elements, was established by the admission into evidence of the Notice of Deficiency dated April 21, 2000 covering the taxpayer’s tax years ending 12/31/92, 12/31/93 and 12/31/94, and the Notice of Deficiency dated January 12, 2001, covering the taxpayer’s tax years end 12/31/95, 12/31/96 and 12/31/97. Stip. Ex. 6.
2. The taxpayer filed timely Illinois corporate income tax returns, and subsequent amended returns reporting Federal RARs for each of the years 1983, 1984 and 1985. Stip. Ex. 1A; Stip. Ex. 1B.¹
3. The taxpayer and its subsidiaries were included in a combined return filed by "Omicron Petroleum Corp." ("OPC") and its subsidiaries pursuant to Section 304(e) of the Illinois Income Tax Act (“IITA”), 35 ILCS 5/304(e) for each of these years;

¹ While Stip. ¶ 18 states that the “parties’ settlement agreement is attached as Stip. Ex. 1A, and the Department’s statement in support of the agreement is attached as Stip. Ex. 1B”, pages 7 – 13 of Stip. Ex. 1A consists of the settlement agreement and the first 7 pages of the Department’s supporting statement. The remainder of the Department’s supporting statement is contained in Stip. Ex. 1B.

"OPC" filed combined returns for two distinct unitary business groups for the aforementioned tax years including a return for a transportation group (filed as a separate unitary group pursuant to 35 ILCS 5/1501(a)(27)), and a combined return for all of its other subsidiaries. Stip. ¶ 14; Stip. Ex. 1A.

4. "OPC" is a holding company. Through its subsidiaries, "OPC" explores for, develops, produces and markets crude oil, natural gas and gas liquids; engages in interstate and intrastate natural gas transmission and marketing; manufactures and markets a variety of industrial chemicals, petrochemicals and plastics and a number of agricultural products; produces and markets fresh beef and pork and their allied products; and mines, processes and markets coal. Stip. ¶ 7.
5. Taxpayer and its subsidiaries (the Meat Processing Group), wholly-owned direct and indirect subsidiaries of "OPC" until 1987, are engaged in the agribusiness which consists principally of beef and pork processing. Stip. ¶¶ 3, 8, 9.
6. The Department audited combined returns filed by "OPC" and its subsidiaries for 1983, 1984 and 1985; following this audit, the Department issued Notices of Deficiency to "OPC" and its subsidiaries dated April 28, 1988 (covering 1983), October 17, 1989 (covering 1984) and December 11, 1989 (covering 1985); these assessments were based upon the Department's determination that "OPC" should have filed combined returns for six distinct unitary business groups consisting of:
 - a) A Natural Resources Group;
 - b) A Meat Processing Group;
 - c) A Holding Company Group;

- d) An Excluded Companies Group; and
- e) Two different transportation company groups. Stip. ¶ 15; Stip. Ex.

1A.

7. The Department also excluded "OPC" from the six unitary business groups that it identified on the basis of a Department policy prohibiting the allocation or proration of a holding company's losses to the unitary business groups making up the company's holdings. Stip. ¶ 19; Stip. Ex. 1A.
8. "OPC", on behalf of the taxpayer and its other subsidiaries, filed Protests and Requests for Administrative Hearing for 1983, 1984 and 1985 on June 7, 1988 (for 1983), November 27, 1989 (for 1984) and January 8, 1990 (for 1985). Stip. Ex. 1A.
9. On September 30, 1993, "OPC" and its subsidiaries, including "IBPPI" and its subsidiaries and "Madwand Corp.", parent company of a group of affiliated corporations which owns and operates pipelines transporting natural gas, acquired by "OPC" on March 31, 1986, and its subsidiaries entered into a Settlement Agreement ("settlement") with the Department settling the tax liabilities of these companies for the tax years ending December 31, 1981 through December 31, 1987; as part of this settlement, the Department withdrew its NOD's, determined that the taxpayers overpaid taxes for these tax periods and awarded them refunds in the amount of \$805,113 plus statutory interest (\$542,480.38 net of an offset for an assessed liability for 1989 of \$262,632.62 plus statutory interest). Stip. ¶ 17; Stip. Ex. 1A.

10. Pursuant to the settlement, the Department also agreed that "OPC" and its subsidiaries should be divided into three distinct unitary business groups: a Natural Resources Group, a Meat Processing Group (which included "IBPPI"PI") and a Transportation Group, and that "OPC's" losses should be allocated among these groups²; this allocation was effectuated by applying a "comparative gross receipts method" to those "OPC" items not specifically attributable or allocable to a particular business group³; the Department also agreed to attribute "OPC's" allocation fractions used to apportion income to the Natural Resources, Meat Processing and Transportation Groups based upon the relative gross receipts of each of these groups. Stip. ¶¶ 17, 20, 21, 23, 24, 25; Stip. Ex. 1A; Stip. Ex. 1B; Stip. Ex. 2.

11. During the tax years ending December 31, 1983 through December 31, 1985 covered by the settlement, "OPC" incurred net operating losses on a separate company basis as indicated below.

<u>YEAR</u>	<u>NET OPERATING LOSSES</u>
1983	\$(428,880,726)
1984	\$(659,697,118)
1985	\$(643,787,992)

Stip. ¶ 22.

² Losses of "OPC" allocated among the unitary business groups agreed to by the parties pursuant to the settlement included losses of "Omicron Petroleum Investment Company". Stip. Ex. 1A.

³ Under the comparative gross receipts method, the income or loss of a parent holding company is allocated to the company's holdings using a ratio, the numerator of which is the gross receipts of the particular unitary business group to which the income or loss is allocated, and the denominator of which is the sum of the gross receipts of all the unitary business groups to which the income or loss of the holding company is allocated. Stip. ¶ 21.

12. The division of "OPC's" losses among the three unitary business groups agreed to in the settlement resulted in the allocation of losses to each of these unitary business groups as indicated below.

1983

<u>UNITARY BUSINESS GROUP</u>	<u>NET OPERATING LOSSES</u>
Natural Resources Group	\$(249,675,488)
Meat Processing Group (including "IBPPI")	\$(99,214,694)
Transportation Group	\$(177,557)

1984

<u>UNITARY BUSINESS GROUP</u>	<u>NET OPERATING LOSSES</u>
Natural Resources Group	\$(230,104,334)
Meat Processing Group (including "IBPPI")	\$(249,364,851)
Transportation Group	\$(403,735)

1985

<u>UNITARY BUSINESS GROUP</u>	<u>NET OPERATING LOSSES</u>
Natural Resources Group	\$(246,465,390)
Meat Processing Group (including	\$(255,515,059)

"IBPPI")	
Transportation Group	\$(1,288,120)

Stip. ¶ 23.

13. Prior to taking into account its allocable share of "OPC's" net operating losses, "IBPPI" and its subsidiaries had federal taxable income of \$72.1 million for 1983, \$76.5 million for 1984 and \$129.2 million for 1985. Stip. Ex. 3; Taxpayer brief p. 6.

14. In accordance with the settlement, the Meat Processing Group included its allocated share of "OPC's" net operating losses in the calculation of its Illinois taxable income for 1983, 1984, 1985, 1986 and 1987. This group's allocated portion of "OPC's" net operating losses taken into account in computing Illinois taxable income was as indicated below.

<u>YEAR</u>	<u>NET OPERATING LOSSES</u>
1983	\$(99,214,694)
1984	\$(249,364,851)
1985	\$(255,515,059)
1986	\$(318,703,550)
1987	\$(48,419,640)

Stip. ¶ 26.

15. The inclusion of "OPC's" net operating losses in the Meat Processing Group's taxable income calculations created federal net operating losses before apportionment for the Meat Processing Group for the tax years 1983, 1984 and 1985 as indicated below.

<u>YEAR</u>	<u>NET OPERATING LOSSES</u>
1983	\$(27,132,235)
1984	\$(172,855,004)
1985	\$(126,350,029)

Stip. ¶ 27.

16. In October, 1987, "OPC" sold 49.5% of its "IBPPI" common stock to an unrelated third party. After 1987, "IBPPI" no longer included "OPC" in the taxable income calculation of "IBPPI's" unitary business group. Stip. ¶¶ 10, 28; Stip. Ex. 3.

17. On September 4, 1991, at the request of "OPC", "IBPPI" filed an underwritten rights offering with the Securities and Exchange Commission, under which "OPC" offered the rest of its "IBPPI" common stock to its stockholders and certain standby underwriters; after this offering, "OPC" no longer owned any shares of "IBPPI" common stock. Stip. ¶ 11.

18. For the tax years 1988 through 1993, "IBPPI" deducted pre-apportionment federal net operating losses resulting from the inclusion of "OPC's" net operating losses in "IBPPI's" taxable income calculations on its Illinois income tax returns as indicated below.

<u>YEAR</u>	<u>NET OPERATING LOSSES</u>
1988	\$(82,692,333)
1989	\$(43,879,881)
1990	\$(56,827,460)
1991	\$ 0

1992	\$(55,417,750)
1993	\$(84,045,526)

Stip. ¶ 30.

19. Pursuant to the settlement, the Meat Processing Group was also allocated a portion of "OPC's" losses in 1986 and 1987 which resulted in "IBPPI" Illinois net operating losses ("INOL") for these years⁴; the Department disallowed the carry forward of these INOL's, which had been carried forward by the taxpayer to 1993, 1994 and 1995, as indicated below.

<u>YEAR</u>	<u>1986 INOL</u>	<u>1987 INOL</u>
1993	\$(555,852)	\$ 0
1994	\$(17,078,549)	\$(9,496,849)
1995	\$ 0	\$(11,363,931)

Stip. ¶ ¶ 31, 35; Stip. Ex. 1A; Stip. Ex. 1B; Taxpayer Brief p. 7.

20. The Department allowed "IBPPI" to use its 1986 INOL to offset "IBPPI's" income in 1988, 1989 and 1990, as indicated below.

<u>YEAR</u>	<u>1986 INOL</u>
1988	\$(12,125,315)
1989	\$(4,776,302)

⁴ Commencing with taxable years ending on or after December 31, 1986, Illinois does not follow federal rules and has its own provisions for computing net operating loss carryforwards and carrybacks. See 86 Ill. Admin. Code § 100.2300; 86 Ill. Admin. Code § 100.2310; 86 Ill. Admin. Code § 100.2340. Losses computed under these rules are called Illinois net operating losses.

1990	\$(732,784)
------	--------------

Stip. ¶¶ 31, 35.

21. The Department allowed "IBPPI" to use its 1987 INOL to offset "IBPPI's" income in 1990, 1991, 1992, 1993 and 1994, as indicated below.

<u>YEAR</u>	<u>1987 INOL</u>
1990	\$(6,658,796)
1991	\$(132,996)
1992	\$(5,036,033)
1993	\$(8,075,505)
1994	\$(676,013)

Stip. ¶ 35

22. For the tax years 1988 through 1993, the Meat Processing Group deducted pre-apportionment federal net operating losses resulting from the inclusion of "OPC's" pre-1986 federal net operating losses in the Meat Processing Group's taxable income calculations on its Illinois income tax returns as follows:

<u>YEAR</u>	<u>NET OPERATING LOSSES</u>
1988	\$(82,692,333)
1989	\$(43,879,881)
1990	\$(56,827,460)
1991	\$ 0
1992	\$(55,417,750)
1993	\$(84,045,526)

Stip. ¶ 30⁵

23. The Department audited the Meat Processing Group for the tax years ending December 31, 1992 through 1997 and determined that the Meat Processing Group was barred from carrying forward any portion of its 1983 through 1985 pre-apportionment Federal net operating loss resulting from the allocation of a portion of the "OPC" loss for those years under 86 Ill. Admin. Code, ch. 1, sec. 100.2230 (formerly 86 Ill. Admin. Code, ch. 1, sec. 2750) as a result of its sale of 49.5% of "IBPPI" stock in October 1987, and its subsequent sale of its remainder of "OPC" stock in 1991⁶. Stip. ¶ 32; Dept. brief pp. 5, 6.

24. The Department timely issued "IBPPI", as designated agent of the Meat Processing Group, a Notice of Deficiency on April 21, 2000 for the 1992, 1993 and 1994 tax years; this NOD reflects a denial of the Meat Processing Group's carryforward of any portion of the 1983, 1984 and 1985 pre-apportionment federal net operating losses allocated to it by "OPC" by the settlement to its 1992 and 1993 Illinois income tax returns, and proposes to assess additional tax of \$1,891,808 and interest of \$824,698 for the 1992, 1993 and 1994 tax years. Stip. Ex. 6; Taxpayer brief p. 7.

⁵ Since the Meat Processing Group did not have taxable income for 1986 and 1987, this group could not carry over its 1983, 1984 and 1985 federal net operating losses to its 1986 and 1987 taxable years. Dept. brief p. 5.

⁶The Department allocated the Meat Processing Group's 1983, 1984 and 1985 losses exclusively among members of the group with losses. The Meat Processing Group had members with losses in 1983, 1984 and 1985 ("IBPPI Properties and ABC"). These loss members were allowed to carryforward losses they incurred in these years to 1988. Stip. ¶¶ 33, 34; Stip. Ex. 5; Dept. brief pp. 4, 5, 6.

- 25.** On June 16, 2000, "IBPPI" timely filed a Protest to the Department's April 21, 2000 NOD for the 1992, 1993 and 1994 tax years; on April 4, 2001, it filed an amended protest to this NOD. Taxpayer brief p. 7.
- 26.** The Department timely issued "IBPPI", as designated agent of the Meat Processing Group, a Notice of Deficiency on January 12, 2001 for the 1995, 1996 and 1997 tax years; this NOD reflects a denial of the Meat Processing Group's carryforward of INOL's which resulted from the Department's denial of pre-1986 NOL carryforwards to 1992 and 1993 and the consequent use of INOLs in earlier years in lieu of disallowed pre-1986 NOL's; the taxpayer timely protested the Department's January 12, 2001 NOD. Stip. ¶¶ 31, 32, 35; Taxpayer Brief p. 7.
- 27.** On September 30, 2002, the taxpayer filed a Motion for Summary Judgment in this case. This motion was subsequently withdrawn by letter dated October 4, 2002, which was signed by the taxpayer and the Department and is included as part of the taxpayer's brief.

Conclusions of Law:

The issue presented in this case involves whether the taxpayer's pre-1986 net operating losses ("NOL's"), which were largely attributable to the taxpayer's parent prior to 1987, should be carried forward to tax years 1992 and 1993. Specifically, the Department has refused to allow "IBPPI" and its subsidiaries (hereafter the "Meat Processing Group") to carry forward net operating losses which were created through the allocation to the Meat Processing Group of losses incurred in 1983, 1984 and 1985 by the taxpayer's then parent, OPC Company . The dispute arose after "OPC" sold its entire interest in the Meat Processing Group in 1987 (when it sold 49.5%

of its shares) and 1991 (when it sold the remainder of its interest). Stip. ¶¶ 10, 11. Following these sales, "IBPPI" and "OPC" ceased to be members of the same unitary business group. See 35 ILCS 1501(a)(27) (definition of "unitary business group", which requires members to be "related through common ownership"). Since there had been a change in the composition of the unitary business group after 1987, the Department disallowed the 1983, 1984 and 1985 net operating losses to "IBPPI" for years subsequent to these events pursuant to 86 Ill. Admin. Code §100.2230. The Department determined that the taxpayer's 1986 and 1987 net operating losses were incorrectly carried forward as a result of these adjustments. This determination resulted in a finding that additional tax and interest was owed by the taxpayer for the 1995 through 1997 tax years. Stip. ¶ 35; Taxpayer Brief p. 7.

The *prima facie* correctness of the Department's determinations was established through the inclusion of the NOD for 1992, 1993 and 1994, and the NOD for 1995, 1996 and 1997 in the record. Stip. Ex. 6. 35 ILCS 5/904(a). Thereafter, the burden shifted to the taxpayer to prove that the Department's application of the net operating losses at issue here was in error. Balla v. Department of Revenue, 96 Ill. App. 3d 293, 295 (1st Dist. 1981).

"IBPPI" asserts that the Department's disallowance of net operating loss carry forwards resulting from the allocation of "OPC" losses to the Meat Processing Group for 1983 through 1985 is barred by the terms of a settlement agreement between "OPC" and its subsidiaries, including "IBPPI" and its subsidiaries. Taxpayer brief ⁷ pp. 12, 13, 14,

⁷ By letter dated October 4, 2002, included as part of the taxpayer's brief, the taxpayer withdrew its Motion for Summary Judgment filed September 30, 2002, and recast its motion and memorandum in support thereof as its post-hearing brief.

15, 16. The settlement agreement was intended to fully resolve a dispute between "OPC" and its subsidiaries, including the Meat Processing Group, and the Department concerning the composition of various "OPC" unitary business groups for the tax years 1981 through 1987. Stip. Ex. 1A.

In their returns for 1983, 1984 and 1985, "OPC" and its subsidiaries (including "IBPPI" and its subsidiaries) divided their business activities into two distinct unitary business groups. Stip. ¶ 14; Stip. Ex. 1A. The Department determined that this formulation of "OPC's" unitary businesses was incorrect and assessed tax and interest. Stip. ¶ 15; Stip. Ex. 1A. This assessment was based on the Department's finding that "OPC" and its subsidiaries should have filed as six different unitary business groups as follows:

- a) A Natural Resources Group;
- b) A Meat Processing Group;
- c) A Holding Company Group;
- d) An Excluded Companies Group; and
- e) Two different transportation company groups. *Id.*

Moreover, the Department found that "OPC", a holding company with substantial NOL's, should not have been included in any of these unitary business groups. Stip. ¶ 19. The taxpayer filed protests contesting these and other findings of the Department. Stip. Ex. 1A.

"OPC" and its subsidiaries (including "IBPPI" and its subsidiaries) ultimately entered into a settlement agreement settling this dispute. Stip. Ex. 1A. As part of this settlement agreement, the Department agreed that the businesses of "OPC" and its

subsidiaries should be divided into three distinct unitary business groups, a Natural Resources Group, a Meat Processing Group which included "IBPPI", and a Transportation Group. Stip. ¶¶ 3, 17. It also agreed that the attributes of "OPC", including its substantial net operating losses, should be reflected in each of these groups. Stip. ¶ 20. These losses were allocated among the three separate unitary business groups agreed upon using the "comparative gross receipts" method. Stip. ¶¶ 20, 21. As a consequence, "OPC" allocated \$99,214,694 in pre-apportionment federal income tax losses to "IBPPI" and its subsidiaries for 1983, \$249,364,851 in losses for 1984, and \$255,515,059 in losses for 1985. Stip. ¶¶ 23, 26. Prior to the allocation of these losses to it, the Meat Processing Group had net income for each of these years in the amount of \$72.1 million for 1983, \$76.5 million for 1984 and \$129.2 million for 1985. Stip. Ex. 3; Taxpayer brief p. 6. The allocation of "OPC" loss to the Meat Processing Group resulted in pre-apportionment federal net operating losses for this group in the amount of \$27,132,235 for 1983, \$172,855,004 for 1984 and \$126,350,029 for 1985. Stip. ¶ 27; Stip. Ex. 3. "IBPPI" contends that the Department's refusal to allow it to carry forward these losses not applied in prior years to 1992 and 1993 is a blatant violation of the terms of the settlement agreement with the Department that covers 1983 through 1985. Taxpayer brief pp. 12, 13, 14, 15, 16.

Computation of Net Operating Loss Carryforwards – Application of 86 Ill. Admin. Code, ch. 1, § 100.2230(b)

For Illinois tax purposes, federal net operating losses of a unitary business group occurring before December 31, 1986 must first be used in the year they occur to offset taxable income of other group members in arriving at combined pre-apportioned federal

taxable income. 86 Ill. Admin. Code § 100.2220. No carryback or carryforward is allowed to the extent that such federal pre-apportioned NOL is absorbed in arriving at combined federal taxable income. 86 Ill. Admin. Code § 100.2230.

If the group has a combined pre-December 31, 1986 pre-apportionment federal net operating loss, this loss must be divided among group members that incur federal net operating losses for Illinois tax purposes. *Id.* This division is to be made pro rata based solely upon the relative size of the federal net operating losses for Illinois purposes of the members with such losses. *Id.* Such members are allowed to individually carry back or carry forward their respective share of the combined federal net operating losses in conformity with Internal Revenue Code (“IRC”) § 172 , 26 USCA § 172.

Notably, the amount that may be carried forward is limited to the sum of income and losses for Illinois purposes in the carry forward year for the loss member and any other member of the same unitary group in that year and in the year that the loss was incurred. 86 Ill. Admin. Code § 100.2230(b) (hereinafter “rule 100.2230(b)”). With respect to this restriction on the use of loss carryforwards, rule 100.2230(b) provides as follows:

(b) In the event that the group members’ federal taxable incomes for Illinois income tax purposes and federal net operating losses for Illinois income tax purposes result in a combined federal net operating loss, this loss will be divided among those group members which incur federal net operating losses for Illinois income tax purposes. This division will be made pro rata based on the relative size of the federal net operating losses for Illinois income tax purposes of the members having such losses. The members will then individually carry back or carry forward their respective shares of the combined federal net operating loss in conformity with the applicable provisions of 26 U.S.C. 172, i.e. generally 3 year carryback and 15 year carryforward

... However, the amount of the loss that the individual member (hereinafter sometimes referred to as the “loss member”) can carry back or forward to any year shall be limited to the lesser of the following amounts computed with respect to the carryback or carryforward year.

- 1) (hereinafter sometimes referred to as Limitation No. 1) The sum of the federal taxable incomes and federal net operating losses for Illinois income tax purposes in that year for the loss member and any other person that was a member of the same unitary business group as the loss member in that year and in the year that the loss was incurred by the loss member.
- 2) (hereinafter sometimes referred to as Limitation No. 2) The combined federal taxable income for that year of any unitary business group to which the loss member belonged.

86 Ill. Admin. Code § 100.2230(b)

Rule 100.2230(b) defines a “loss member” of a unitary business group eligible to carry forward a pre-1986 pre-apportionment federal net operating loss as a company having net operating losses prior to 1986 for Illinois income tax purposes. With the exception of "IBPPI" Properties and ABC, "IBPPI" and its subsidiaries did not qualify as loss members of the unitary business group that included "OPC" for 1983 through 1985 under rule 100.2230. Stip. ¶ 34. The principal loss member of this group was "OPC". The record shows that "OPC" had substantial federal income tax losses during these years, while "IBPPI" and most of its subsidiaries had net income. Stip. § 22; Stip. Ex. 3; Taxpayer brief p. 6. While a portion of "OPC's" loss was allocated to the Meat Processing Group under the settlement agreement, the status of "IBPPI" and its subsidiaries not having pre-1986 NOL's as de facto loss corporations only pertained to the years covered by this agreement.

In sum, "OPC" was the principal loss member of the Meat Processing Group in 1983, 1984 and 1985. However, "OPC" could not carry forward its losses to offset the

Meat Processing Group's net income in years after 1987 because "OPC" was no longer a member of the same unitary business group as "IBPPI" after that year. Stip. ¶ 28. Rule 100.2230(b) requires that when a loss member leaves a unitary business group, any remaining member of the group, when computing its liabilities, take into account the loss member's loss only for the tax periods that the loss member was a member of the group. "IBPPI" and most of its subsidiaries could not be treated as loss members because, with the exception of "IBPPI" Properties and ABC, they had pre-1986 federal taxable income. Stip. Ex. 3. Only taxpayers with pre-1986 NOL's can be treated as loss members under rule 100.2230(b). Since "OPC" left the unitary business group in 1987, the Department's assertion that rule 100.2230(b) bars the carryforward of losses attributable to "OPC" to years after "OPC's" departure from the group is a correct application of rule 100.2230(b) to the facts presented in this case.

Rule 100.2230(b) is not unlike rules limiting loss carryforwards that applied for Federal tax purposes prior to the enactment of Federal provisions limiting loss carryforwards that are not applicable in Illinois.⁸ Woolford Realty Co. v. Rose, 286 U.S. 319 (1932); New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934); Libson Shops, Inc. v. Koehler, 353 U.S. 382 (1957). The obvious purpose of these limitations is to limit corporate tax benefits from losses created by a pool of capital or entity to the income

⁸ IRC § 382, 26 USCA § 382, enacted in 1954, limits the use of net operating loss carryforwards where a substantial change in the corporation's stock ownership is effected in any manner, whether by purchase, new issue, redemption, reorganization, or a combination thereof. However, according to 35 ILCS 5/207, taxable net losses are allowed as carryover or carryback deductions in the manner allowed under IRC § 172, 26 USCA § 172. This treatment is allowed for any taxable year ending prior to December 31, 1999. Since 35 ILCS 5/207 does not limit the amount of losses that may be carried to any given year, the limitations on loss carryforwards and carrybacks indicated in IRC § 382, 26 USCA § 382, are not applicable in Illinois. See also 35 ILCS 5/405 and 86 Ill. Admin. Code § 100.4500 codifying this tax treatment of NOLs.

from the pool of capital or entity that generated these loss benefits. Woolford Realty Co., *supra*; New Colonial Ice Co., *supra*; Libson Shops, *supra*. Similar limitations on loss carryforwards in other states have been upheld in a number of cases. Farrell Enterprises, Inc. v. Commissioner of Revenue, 46 Mass. App. Ct. 564 (1999); Fidelcrest Mills, Inc. v. Coble, 290 N.C. 586 (1976); Holly Farms Poultry Industries, Inc. v. Clayton, 9 N.C. App. 345 (1970) ; Bell South Telecommunications, Inc. v. North Carolina Department of Revenue, 126 N.C. App. 409 (1997).

Impact of Settlement Agreement

The taxpayer's main argument is that the Department forfeited its right to enforce rule 100.2230(b) so as to limit the loss carryforward of losses allocated to "IBPPI" and its subsidiaries when it entered into the settlement. See Taxpayer brief p. 15 ("The Department cannot now alter the settlement agreement by applying the provisions of Illinois Regulation 100.2230 to reallocate the losses allocated to the Meat Processing Group pursuant to the Settlement Agreement ... "). Accordingly, the principal issue in this case is whether the settlement can be read to abrogate the otherwise proper application of rule 100.2230(b) to limit the taxpayer's loss carryforwards in this case.

A settlement agreement is a contract. Herron v. City of Chicago, 618 F. Supp. 1405, 1409 (D.C. Ill., 1985). Accordingly, in interpreting the terms of a settlement agreement the court looks to state law governing the interpretation of contracts. *Id.* The court's primary objective in construing a contract is to ascertain the intent of the parties and give effect to that intent. *Id.*; Schek v. Chicago Transit Authority, 42 Ill. 2d 362 (1969).

In this case, the settlement agreement is completely silent as to the applicability of rule 100.2230(b) to the Meat Processing Group's loss carryforwards created by this agreement. Parties to a contract are presumed to know the law pertaining to their contractual agreement. Monroe Dearborn Limited Partnership v. Board of Education of the City of Chicago, 271 Ill. App. 3d 457, 462 (1st Dist. 1995). Accordingly, it is assumed that "OPC" and its subsidiaries, including the Meat Processing Group were aware of rule 100.2230 and its potential effect on the Meat Processing Group's loss application subsequent to "OPC's" departure from this unitary group. Indeed, the potential problem to the taxpayer posed by this regulation should have been obvious to the taxpayer at the time the agreement was signed in 1993, which was after "OPC's" sale of the Meat Processing Group beginning in 1987. Stip. ¶¶ 10, 11, 28; Stip. Ex. 1A. Accordingly, it is reasonable to conclude that the settlement agreement's failure to address the applicability of this regulation means that the parties intended not to vary the legal effect of rule 100.2230 on loss carryforwards.

Moreover, the settlement agreement, at ¶ 6 (e), states as follows:

- e) Nothing herein shall be construed, explicitly or implicitly, to waive any right, claim, or defense not otherwise addressed herein that may be provided to any party to this agreement by the laws then in effect to enforce or challenge the audit results.

This language preserves all of the parties' legal rights not expressly waived by the settlement agreement's terms. While section 6 of the settlement only covers 1989, and is only applicable to that period, it is indicative of a general intent not to abrogate legal

rights that are not expressly waived. Since the law⁹ grants the Department the right to limit loss carryforwards pursuant to regulation 100.2230, this provision of the settlement agreement supports the Department's claims.

Most importantly, the settlement agreement is expressly limited to the settlement of tax liabilities for the period 1981 through 1987. Stip. Ex. 1A. The only mention of tax years subsequent to these years is contained in the preamble, which addresses the tax periods ended December 31, 1988 and December 31, 1989, and ¶ 6 covering the Department's 1989 audit. *Id.* There is no mention of the tax periods at issue in this case. The settlement agreement's failure to cover these tax periods is a strong indication of the parties' intent not to address the issues raised by the carry forward of net operating losses to these years or vary the law otherwise applicable to these periods.

The taxpayer points to the statement in the settlement documents that "NOLs were created for the "IBPPI" Meat Processing Group" as evidence of the parties intent to allow the carryforwards the taxpayer seeks. Taxpayer brief pp. 13, 16. This language is included in a section of the Department's supporting statement entitled "Proration or allocation of holding company operating loss to Unitary business groups". Stip. Ex. 1A. The clear intent of this section is to address the manner in which holding company losses are to be attributed to companies that were part of unitary business groups consisting of "OPC" and its subsidiaries in 1983, 1984 and 1985. Accordingly, this section only deals with the creation of NOL's through the allocation of losses to the Meat Processing Group.

⁹ Regulations have the force and effect of laws in Illinois. Northern Illinois Automobile Wreckers & Rebuilders Association v. Dixon, 75 Ill. 2d 53 (1979), cert. den. 444 U.S. 844 (1979); Craftmasters, Inc. v. Department of Revenue, 269 Ill. App. 3d 934 (4th Dist. 1995); Union Electric Co. v. Department of Revenue, 136 Ill. 2d 385 (1990); Eastman Kodak v. Fair Employment Practices Commission, 86 Ill. 2d 60 (1981); Schmidt v. Department of Revenue, 163 Ill. App. 3d 269 (5th Dist. 1987).

The settlement agreement does address the possible impact of these NOL's on future audits through 1989, and acknowledges that these losses might result in tax benefits for these years. Stip. Ex.1A, p. 1; Stip. Ex. 1B, pp. 8, 9, 10. However, nowhere does it address the application of these NOL's as carryforwards after 1989.

In sum, the intent of the parties, as evidenced by the terms of the settlement agreement giving rise to the losses the taxpayer seeks to carry forward, does not contain any language to suggest that the parties intended to modify the application of rule 100.2230(b). The intent of the parties was clearly to resolve their liabilities only for the tax periods covered by the settlement. As a result of this settlement, "OPC" and its subsidiaries, including the taxpayer received a refund of tax for 1981 through 1987 of \$805,113 plus interest. Stip. Ex. 1A. ("OPC" and its subsidiaries received a net refund of \$542,480.36 determined by offsetting the refund noted above against an assessed liability of \$262,632.62 for 1989). While the parties were clearly aware of rule 100.2230, which was formerly 86 Ill. Admin. Code 100.2750 (mentioned at Stip. Ex. 1B, p. 2), there is no reference in the settlement documents to the impact of rule 100.2230 on carryforwards after 1989. Accordingly, I find no basis for construing the settlement agreement to favor the taxpayer's position.

Inclusion of "OPC" and the Meat Processing Group in a single Unitary Business

The taxpayer also argues that "OPC" and the Meat Processing Group were not engaged in a unitary business during 1983, 1984 and 1985. Taxpayer reply brief, pp. 1, 2, 3, 4. If the taxpayer is correct in this contention, rule 100.2230, which has been applied by the Department to limit the Meat Processing Group's net operating loss carry

forwards, would be inapplicable here. This regulation only addresses the treatment of net operating losses of unitary business groups occurring before December 31, 1986.

The record in this case primarily consists of a stipulation of facts and the settlement agreement. In both of these documents, the taxpayer agreed that the business activities of "OPC", "IBPPI" and their subsidiaries were properly divided into 3 business groups, a Natural Resource Group, a Meat Processing Group and a Transportation Group. Moreover, both the stipulation and the settlement agreement identify these divisions as unitary business groups. See Stip. ¶¶ 23 ("In accordance with the terms of the settlement agreement, "OPC's" net operating losses were divided among the three unitary groups using the comparative gross receipts method"), 24, 25, 26, 28, 32, 33, Stip. Ex. 1A (Exhibit A). Further, the computation of losses contained in these documents creates tax benefits that substantially reduced tax liabilities during the period covered by the settlement, by including "OPC" in each of these groups. Stip. ¶¶ 22, 23, 24, 25, 26, 27; Stip. Ex. 1A, 1B, 2, 3, 4. These tax benefits would not exist if the parties had not agreed to the inclusion of "OPC" in the three unitary groups in their settlement agreement. The taxpayer cannot characterize these groups as unitary in order to obtain tax benefits under the settlement agreement and simultaneously disavow unitary treatment in order to avoid the loss of NOL carryforwards to years after those the settlement covers.

The Illinois courts have repeatedly held that an agreed stipulation is binding on the parties and conclusive as to all matters necessarily included therein. Plano Foundry Co. v. Industrial Commission, 356 Ill. 186 (1934); Higginbotham v. American Family Insurance Co., 143 Ill. App. 3d 398 (3rd Dist. 1986); Hudson v. Safeway Insurance Co.,

106 Ill. App. 3d 391 (1st Dist. 1982); In Re Marriage of Brand, 123 Ill. App. 3d 1047 (4th Dist. 1984). Accordingly, this tribunal is not at liberty to reach conclusions that contradict what has already been settled and agreed to by the parties. Schrayer v. McCarthy, 234 Ill. App. 528 (1st Dist. 1924); Parker v. Board of Trustees of Southern Illinois University, 74 Ill. App. 2d 467 (5th Dist. 1966); Shell Oil Co. v. Industrial Commission, 407 Ill. 186 (1950); Gietl v. Commissioners of Drainage District No. 1, 384 Ill. 499 (1943); Montgomery Ward & Co. v. Industrial Commission, 304 Ill. 576 (1922). Since "IBPPI" has agreed that "OPC" was part of "IBPPI's" Meat Processing Group in its settlement agreement and in the stipulations contained in the record, it cannot now repudiate its prior representations by arguing that "IBPPI" and "OPC" are not unitary.

Even if the settlement agreement and the stipulations were not conclusive, the record does not support the taxpayer's claim that it has rebutted the Department's finding of a unitary business. Taxpayer reply brief pp. 1, 2, 3, 4. The determination of whether a company should be included in a unitary business group is a question of fact. Citizens Utilities Company of Illinois v. Department of Revenue, 111 Ill. 2d 32, 47 (1986); A.B. Dick Co. v. McGraw, 287 Ill. App. 3d 230, 236 (1977). Indications of a unitary business are functional integration, economies of scale, and direct transfers of value, because contributions of each entity increase the taxable income of all of the other entities. Citizens Utilities, *supra*. By arguing that "OPC" and the taxpayer were not unitary, the taxpayer implicitly maintains that these indicia of unity between "OPC" and the Meat Processing Group were non-existent during 1983, 1984 and 1985.

Section 1501(a)(27) of the Illinois Income Tax Act, 35 **ILCS** 5/1501(a)(27), defines the term “unitary business group” in relevant part as follows:

Unitary business group. The term “unitary business group” means a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other ... Common ownership in the case of corporations is the direct or indirect control or ownership of more than 50% of the outstanding voting stock of the persons carrying on unitary business activity. Unitary business activity can ordinarily be illustrated where the activities of the members are: (1) in the same general line (such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation or finance); or (2) are steps in a vertically structured enterprise or process (such as the steps involved in the production of natural resources, which might include exploration, mining, refining, and marketing); and, in either instance, the members are functionally integrated through the exercise of strong centralized management (where, for example, authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member)

35 **ILCS** 5/1501(a)(27)

This section of the Illinois Income Tax Act sets forth two requirements for determining whether a group of corporations are a unitary business group within the meaning of this Act. The first requirement is that there must be common ownership of over 50% of the outstanding stock of the corporations in the group. Since the record shows that "OPC" directly or indirectly owned all of the outstanding stock of the Meat Processing Group in 1983, 1984 and 1985, this criterion has clearly been met. Stip. ¶¶ 8, 9, 10.

The second requirement addresses the business activity of the corporations in the group. It provides that “(U)nitary business activity can ordinarily be illustrated where the activities of the members are: (1) in the same general line (such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation or finance); or (2) are steps in a vertically structured enterprise or process (such as the steps involved in the production of natural resources, which might include exploration, mining, refining, and marketing)”. 35 **ILCS** 5/1501(a)(27). While products of

"OPC's" various unitary business groups differed substantially, these groups were principally engaged in the same line of business, manufacturing and related activities. The statutory test to determine whether a group of entities that are engaged in the same line of business are unitary is to determine whether they are "functionally integrated through the exercise of strong centralized management" *Id.*

The Department's regulation concerning strong centralized management, 86 Ill.

Admin. Code § 100.9700(g), provides in relevant part as follows:

Strong centralized management. Under IITA Section 1501(a)(27), no group of persons can be a unitary business group unless they are functionally integrated through the exercise of strong centralized management ... (that is) ... the primary indicator of mutual dependency, mutual contribution and mutual integration between persons that is necessary to constitute them members of the same unitary business group. The exercise of strong centralized management will be deemed to exist where authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member. Thus, some groups of persons may properly be considered as constituting a unitary business group under IITA Section 1501(a)(27) when the executive Officers of one of the persons are normally involved in the operations of the other persons in the group and there are centralized units which perform for some or all of the persons functions which truly independent persons would perform for themselves. Note in this connection that neither the existence of central management authority, nor the exercise of that authority over any particular function (through centralized operations), is determinative in itself; the entire operations of the group must be examined in order to determine whether or not strong centralized management exists. A finding of "strong centralized management" cannot be supported merely by showing that the requisite ownership percentage exists or that there is some incidental economic benefit accruing to a group because such ownership improves its financial position. Both elements of strong centralized management, i.e., strong central management authority and the exercise of that authority through centralized operations, must be present in order for persons to be a unitary business group under IITA Section 1501(a)(27). Finally, a finding of strong centralized management can be supported even though the authority resides in a person that is not a member of the group, provided that the authority is actually exercised by such person.

86 Ill. Admin. Code § 100.9700(g)

The taxpayer implicitly contends that a showing of strong centralized management sufficient to treat the Meat Processing Group and "OPC" as members of the same unitary business group was never made in this case. It contends that any presumption establishing the prima facie correctness of such a finding as a result of section 904(a) of the Illinois Income Tax Act, 35 ILCS 5/904(a) was successfully rebutted. To rebut this presumption, the taxpayer presented evidence that, during its field audit of "OPC" for the years 1983 through 1985, the Department's auditor determined that the criteria necessary to show strong centralized management was not satisfied. Taxpayer reply brief, pp. 1, 2, 3, 4. However, the taxpayer's evidence was itself rebutted by the record, which was stipulated to by both parties. This record is replete with evidence that the Department's audit division subsequently abandoned its position that "OPC" and "IBPPI" were not unitary by agreeing to include the attributes of "OPC" in the Meat Processing Group. Stip. Ex. 1A; Stip. Ex. 2; Stip. Ex. 3. The record contains insufficient additional evidence to establish whether "OPC" exercised strong centralized management over "IBPPI" and its other subsidiaries in this case. Since the Department rebutted the taxpayer's evidence to the contrary, it was incumbent upon the taxpayer to produce such additional evidence showing the absence of centralized management in order to prevail. Balla, supra; Novicki v. Department of Revenue, 373 Ill. 342 (1940). Given the taxpayer's failure to do so, the Department is correct in concluding that the taxpayer failed to meet the requisite burden of proof necessary to show that "OPC" and the Meat Processing Group were not engaged in a unitary business. See Dept. brief pp. 13, 14. Accordingly, the taxpayer has failed to show that the application of the loss limitation provision of rule 100.2230(b), which is applicable to the carryforward of pre-1986 NOL's

of unitary business groups, was improperly applied to limit the Meat Processing Group's net operating loss carry forward in this case.

Moreover, as the Department points out, if this tribunal were to accept the taxpayer's basic premise that "IBPPI" and its subsidiaries were not members of the same unitary business group as "OPC", there would be no legal basis for the allocation of "OPC's" tax attributes to "IBPPI's" Meat Processing Group. Dept. brief, p. 13. The taxpayer's net loss carryforward is premised upon the application of the rules indicated in 86 Ill. Admin. Code § 100.5270(a)(3) governing the computation of combined group income, and 86 Ill. Admin. Code § 100.2230 to "OPC" and the Meat Processing Group. Since "IBPPI" and most of its subsidiaries had net income in 1983, 1984 and 1985, absent the application of these rules, there would be no legal basis for the taxpayer and its subsidiaries with income to claim any loss carryforwards for losses generated by affiliates prior to 1986.

In sum, for the foregoing reasons, I find that the taxpayer has failed to show that rule 100.2230(b) was inapplicable as a consequence of the absence of a unitary relationship between "OPC" and the Meat Processing Group (including "IBPPI") during the tax years 1983 through 1985.

Consistency of 86 Ill. Admin. Code § 100.2230(b) and the Unitary Method of Apportionment

The taxpayer also contends that the application of rule 100.2230(b) to limit "IBPPI's" net operating loss carry forwards from 1983 through 1985 attributable to the allocation of "OPC" losses pursuant to the settlement violates the unitary method of apportionment and is therefore invalid. Taxpayer brief, pp. 16, 17, 18; Taxpayer reply

brief, pp. 5, 6. Specifically, the taxpayer objects to the application of the rule requiring the division of losses solely among unitary business group members that incur federal net operating losses for Illinois tax purposes, where the unitary business group has a combined pre-December 31, 1986 net operating loss under rule 100.2230(b). The gravamen of the taxpayer's claim is that the application of this rule frustrates the purpose of combined reporting, which is to determine the income or tax base of in-state taxpayers by viewing such taxpayers as part of a unitary business.

The Illinois and federal courts have placed a heavy burden of proof on taxpayers seeking to challenge the validity of state apportionment schemes. Citizens Utilities at 52; Butler Brothers v. McColgan, 315 U.S. 501, 507 (1942) (“(O)ne who attacks a formula of apportionment carries a distinct burden of showing by ‘clear and cogent evidence’ that it results in extraterritorial values being taxed ...”). To prevail, the taxpayer must show that “in any aspect of the evidence its income attributable to” the taxing State was “out of all appropriate proportion to the business transacted in that State.” *Id.* One way of meeting this burden is by showing that the apportionment scheme results in the imposition of tax on income arising from business conducted beyond the boundaries of the state. Hans Rees’ Sons, Inc. v. North Carolina, 283 U.S. 123 (1931). In that case, the United States Supreme Court found that the state’s apportionment scheme produced an apportionment of income to North Carolina “out of all appropriate proportion” to the taxpayer’s activities in the taxing state. Hans Rees’ Sons at 135.

The courts have also indicated that, in order to prevail, a taxpayer must show that the apportionment scheme as applied to the taxpayer produces a distorted result. The

issue in Illinois and U.S. Supreme Court cases that have attacked the fairness of state apportionment formulas has involved the application of the formula to each taxpayer's unique circumstances. Citizens Utilities, *supra*; Butler Brothers v. McColgan, *supra*; Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920); Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission, 266 U.S. 271 (1924); Hans Rees' Sons, Inc., *supra*; International Harvester Co. v. Evatt, 329 U.S. 416, 422 – 423 (1947) (“Unless a palpably disproportionate result comes from an apportionment ... which makes it patent that the tax is levied upon interstate commerce rather than upon an intrastate privilege, this Court has not been willing to nullify honest state efforts to make apportionments”). See also Hellerstein & W. Hellerstein, *State Taxation*, 3rd Edition, ¶ 8.12 [1].

In the instant case, the taxpayer has produced no evidence that the application of rule 100.2230(b) governing the allocation of losses to members of a unitary business group grossly distorts the amount of the taxpayer's income or loss apportioned to Illinois. The taxpayer merely contends that inherent flaws in this apportionment procedure could result in an improper allocation or apportionment of income and thus undermine the objectives of combined reporting. While it may be possible to imagine situations where the application of rule 100.2230(b) distorts a taxpayer's apportionable income, in the absence of any evidence of such distortion here, the taxpayer cannot possibly meet the burden required to successfully challenge the application of rule 100.2230(b) in this case.

Moreover, as correctly pointed out by the Department in its brief, a party challenging the validity of a Department regulation bears the burden of proving its invalidity. Dept. brief pp. 14, 15, citing Board of Trustees of the University of Illinois

v. Illinois Educational Labor Relations Board, 274 Ill. App. 3d 145, 148 (1st Dist. 1995).

If a challenged rule or regulation's construction is doubtful, a court may not invalidate an agency's rule or regulation unless it is clearly arbitrary, unreasonable or capricious.

American Federation of State, County & Municipal Employees v. Department of Central

Management Services, 288 Ill. App. 3d 701, 713 (1st Dist. 1997). In this case, the

taxpayer has presented no evidence to show that regulation 100.2230(b) is arbitrary, unreasonable or capricious. Since the taxpayer cannot prevail without making such a showing, I find that the taxpayer has not presented sufficient proof to establish its claim.

As noted above, the Department's denial of the Meat Processing Group's carry forward of the group's 1983 through 1985 net operating losses to 1992 and 1993 resulted in additional tax and interest for the 1995 through 1997 tax years. Stip. ¶ 35; Taxpayer Brief p. 7.

WHEREFORE, for the reasons stated above, it is my recommendation that the Department's Notice of Deficiency for the tax years 1992, 1993 and 1994 and the Department's Notice of Deficiency for the tax years 1995, 1996 and 1997 be finalized as issued.

Ted Sherrod
Administrative Law Judge

Date: December 4, 2002